COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

AT RICHMOND, DECEMBER 18, 2001

APPLICATION OF

APPALACHIAN POWER COMPANY d/b/a AMERICAN ELECTRIC POWER-VIRGINIA

CASE NO. PUE010011

For approval of functional separation plan

ORDER ON FUNCTIONAL SEPARATION

On January 3, 2001, the Appalachian Power Company d/b/a American Electric Power-Virginia ("AEP-VA" or the "Company") filed with the State Corporation Commission ("Commission") an application pursuant to Virginia Code § 56-590 B of the Virginia Electric Utility Restructuring Act (the "Act") and §§ 56-88 through 56-90 of the Utility Transfers Act ("Transfers Act"). Virginia Code § 56-590 B requires each incumbent electric utility to submit a plan for the functional separation of the utility's generation, transmission and distribution assets and operations. Requests to transfer control or operation of utility facilities must also be processed according to the Transfers Act.

AEP-VA's plan involved the corporate separation of its generation assets and operations from its transmission and distribution assets and operations. AEP-VA proposed to form a

non-regulated generation company, called Genco, to which the Company would transfer all generation-related operations and assets that it and its subsidiaries owned or held. The stock of Genco, in return, would be distributed to AEP-VA. The Company would then make a tax-free distribution to its corporate parent, America Electric Power Company, Inc. ("AEP"), of the Genco stock. Genco would be a subsidiary of a proposed, first-tier, wholly owned subsidiary of AEP, initially called "Holdco." AEP-VA would retain all its existing debt until the post-transfer capital structures of Genco and AEP-VA could be established. Genco would operate as an Exempt Wholesale Generator ("EWG"), not subject to regulation by the Commission.[1] The plan also called for the Commission to make certain findings required by the Public Utility Holding Company Act ("PUHCA") as necessary to effect the proposed plan. Finally, because information about certain aspects of its proposed plan were not known at the time of the filing of the application, AEP-VA requested waivers of certain filing requirements set out in our rules.

During its 2001 session, the Virginia General Assembly had before it and eventually enacted substantial revisions to portions of the Act that directly bear upon AEP-VA's filings.

[1] Alternatively, the Company proposed that if corporate separation of the generation assets could not be accomplished, then the transmission and distribution assets instead would be transferred out of AEP-VA, which would retain the generation assets only.

Accordingly, processing of AEP-VA's application was deferred, pending resolution of the legislative initiatives.

On April 11, 2001, we issued our Order for Notice and Hearing, which established the procedural schedule for this matter and described the application and plan in more particular detail.[2] The Company was directed to publish notice of its application in newspapers of general circulation throughout its service territory, and dates were established for filing protests and pre-filed direct and rebuttal testimony and for a public hearing to receive evidence and testimony on the application. The Order responded to the Company's waiver requests and, because the filing lacked a multitude of details needed by the Commission to rule upon the Company proposal, further directed AEP-VA to file all information necessary to effect a functional separation by divisions. In addition, the Order directed the Commission Staff ("Staff") to convene a meeting of all parties in the case on or before July 13 for the purpose of exploring the possibilities for narrowing the issues for hearing through settlement or stipulation.

On May 15, 2001, as directed in the Order, AEP-VA supplemented its filing by submitting information needed to

[2] That Order may be found at http://www.state.va.us/scc/caseinfo/pue/case/e010011.pdf.

effect a plan of functional separation by division, as opposed to the corporate separation plan proffered in its application.

On July 3, 2001, the Staff filed a motion requesting that it be permitted to reschedule the initial prehearing conference until a date on or before August 31, 2001. Staff noted that AEP-VA had notified it that AEP would soon make a filing before the Federal Energy Regulatory Commission ("FERC") that would affect this proceeding. AEP proposed in its FERC filing to make substantial changes to the wholesale power supply agreement that historically governed relations among its operating companies, including AEP-VA. On July 13, 2001, we entered an order granting the motion for extension.

This matter was brought on for hearing on October 29, 2001. Appearances were entered by Anthony J. Gambardella, Esquire, H. Allen Glover, Esquire, and James R. Bacha, Esquire, for the Company; by Thomas B. Nicholson, Esquire, for the Town of Wytheville, Virginia, and the Virginia Association of Counties/Virginia Mutual League Appalachian Power Company Steering Committee ("Local Governments"); by Robert M. Gillespie, Esquire, for the Virginia Cable Telecommunications Association; by Edward L. Petrini, Esquire, for the Old Dominion Committee for Fair Utility Rates; by John F. Dudley, Esquire, for the Office of Attorney General, Division of Consumer Counsel; and by William H. Chambliss, Esquire, Arlen K. Bolstad,

Esquire, and Rebecca W. Hartz, Esquire, for the Commission Staff. Ms. Irene Leech, President of the Virginia Citizens Consumer Council, appeared as a public witness.

At the hearing, the Staff and parties reported that they had been meeting for the purpose of discussing settlement and the narrowing of the issues, had reached conclusions and agreements as to some issues, and intended to continue discussions following the receipt of opening statements and the testimony of certain witnesses whose travel schedules required accommodation.

At the outset of the second scheduled day of hearing, the Staff and several parties offered two stipulations intended to resolve nearly all issues pending among them. One document effected a resolution of the manner of functional separation and the other effected a resolution of the rate unbundling issues, with limited exceptions discussed below. Copies of the Stipulations are appended hereto, but the salient features of each are as follows:

Functional Separation Stipulation. The signatories to this Stipulation agreed that:

(1) On and after January 1, 2002, AEP-VA will continue the current functional separation of its distribution, transmission and generation functions by division and

operate under the terms of its Supplemental Filing (Functional Separation Plan) filed May 15, 2001;

(2) AEP-VA will not impose any wires charge during calendar year 2002;

(3) There will be a further inquiry into the terms and conditions for the proposed transfer of generation assets to an affiliate, to be conducted during calendar year 2002. This inquiry will examine, among other things, conditions necessary for the maintenance of reliable electric service and the development of an effectively competitive market for generation services; and

(4) AEP-VA will continue to use its best efforts to provide reliable service and to minimize generation costs to its retail customers.

Rate Unbundling Stipulation. The signatories to this Stipulation agreed that:

(1) Unbundled generation, transmission and distribution revenues should be those set forth on Exhibit 1, and as described in Paragraph 1.a., of the Stipulation;

(2) The Company's proposed rate designs, except as modified in Paragraph 1.b. of the Stipulation, should be adopted;

(3) The Standard and Open Access Distribution tariffs filed by the Company should be approved, as specifically revised by Paragraph 1.c of the Stipulation;

(4) The fees established in Paragraph 1.d of the Stipulation are reasonable and should be adopted, if the Commission finds the fees to be permissible under the Act;

(5) The Company will file a report regarding the replacement of power from the outage at the Cook Nuclear Power Plant by July 1, 2002; and

(6) Three issues remain to be contested—extension of service provisions, interval metering requirements, and the assignment of net generation related regulatory assets.

The signatories to both documents reserved all rights in all other pending matters both federal and state, and requested that we adopt the Stipulations in whole or, if not, allow any party to withdraw from its agreement and present evidence and testimony. All parties to the proceeding (except the Local Governments) and the Staff signed both documents. Later in the proceeding a third Stipulation, in which the parties agreed that the Company would make no change in its fuel factor recovery mechanism or its specific fuel factor for calendar year 2002,

was offered. This document, too, was signed by the Staff and all parties other than the Local Governments, whose counsel offered a statement that these parties did not oppose the Commission's consideration of all the Stipulations. A copy of this last Stipulation is also attached. Evidence was received during the hearing only as to the issues identified in the Rate Unbundling Stipulation as unresolved.

NOW THE COMMISSION, having considered the evidence of record, the Stipulations offered herein, and the applicable statutes and rules, finds that the Stipulations are reasonable and in the public interest and should be adopted in full. With regard to the remaining contested issues, the Commission finds as follows:

Extension of service provisions. Nearly every utility, including AEP-VA, requires its customers to contribute toward the cost of extending the lines or pipes necessary to provide service, under certain defined conditions. In its application, AEP-VA proposed a significant revision in its line extension policies that would increase the amount of customer-contributed funds for extension of service facilities.

In its current tariffs, AEP-VA provides free service extensions up to 1000 feet for residential customers. Past 1000 feet, customers must pay any clearing costs in excess of $100 per customer to be served by the extension. For certain

commercial customers, the free extension length is 150 feet, with extensions beyond this based upon an economic formula that compares the expected cost of the extension to the expected annual, non-fuel revenue that will result from the extension, multiplied by an annual carrying cost amount.

AEP-VA proposed that all its residential and relevant commercial connections should be determined through application of the formula. It also further proposed that only distribution related revenues be included in the formula's consideration. Previously, expected revenue from all functional components had been included in the calculation of any customer contribution under the formula.

The Commission finds that AEP-VA's proposal to amend its line extension policy should be denied. Under Code § 56-582, the rates for all customer services are capped[3] at the levels in effect as of July 1, 1999, unless a utility filed a rate application before January 1, 2001; AEP-VA did not do so. The capped rate provisions of Code § 56-582 are broad and encompass the rates for extension of service facilities. Further, the Company did not show that it would actually face any significant loss of revenue in the immediate future. Should it prove

[3] The statute permits certain adjustments to these capped rates, some of which are discussed below.

necessary, § 56-582 C of the Act does permit AEP-VA to apply for a distribution rate adjustment in 2004.

Interval Metering. The Company has proposed that customers with maximum monthly billing demands of 200 kW or greater be obligated to install interval metering if they take service from a competitive supplier. The Company cited as a rationale for this requirement that it would otherwise have no adequate way to profile the load characteristics of any particular departing customer and the process of market settlement might be less than perfectly accurate if the customer's hour-by-hour load is unknown. We are not persuaded that AEP-VA customers who shop for electricity from competitive suppliers should be required to install interval metering. While some incremental improvement in settlements may result, the requirement that departing customers pay $300 for an interval meter, plus additional monthly fees for maintenance of a dedicated business telephone line to permit instantaneous meter reading is discriminatory and would also have an anticompetitive effect. The Company does not require its remaining customers at 200 kW or greater to install such metering because it has developed representative load profiles for such customers based on "scientific selection." The Company has not made a sufficient showing that departing customers, if any, will have load characteristics sufficiently different from remaining similarly sized customers to merit this

disparate treatment at this time. We will permit AEP-VA to offer interval metering to any customer that requests this service at the rates set forth in the rate unbundling stipulation.

Assignment of net generation related regulatory assets. Section 56-590 of the Code requires that we direct the separation of each incumbent electric utility's generation, transmission and distribution functions. This provision of the Act further requires that we establish rules prohibiting cost-shifting or cross-subsidies between functionally separate units. AEP-VA has requested that its generation related regulatory assets nonetheless be recategorized as and included within its distribution costs. The Company proposes this treatment for fear that accounting conventions will require the write-off of these costs from its books, on the argument that recovery of these costs is no longer assured by operation of regulated rates. We are not unsympathetic to the Company's position, but find that the Restructuring Act provisions cited above require that we reject it. All costs associated with the generation function must be assigned to the generation function.

While this assignment of costs to the generation function is dictated by the Act, it should not necessitate the write-off of the costs, which the Company wishes to avoid. First, Code § 56-577 A 3 provides that after January 1, 2002, generation

will no longer be regulated "except as provided in this chapter." Similarly, Code § 56-581 A states that generation rates are not regulated *except* "subject to the provisions of this chapter after the date of customer choice[.]" The unbundled rates for generation that we approve in this proceeding pursuant to the Act are an example of continued regulation. The rates are based upon the Company's most recent cost of service study and should provide AEP-VA with a fair opportunity to recover all generation expenses, including the amortization of its regulatory assets. Further, any loss of sales resulting from competition may also be mitigated by the wires charge permitted by § 56-583 of the Act. Specifically, all power not sold to customers that choose to take service from a competitor may be sold on the open market. In addition, from now until 2007,[4] customers may be required to pay the Company a wires charge designed to recover any difference between the market price and the company's unbundled generation rate.[5] Further, by operation of the Stipulation and as provided by Code § 56-582 B, the Company will have assured recovery, on a dollar-for-dollar basis, of a primary component of its generation

[4] The Company may, at its sole discretion, petition the Commission to terminate capped rates as early as July 1, 2004, pursuant to Code § 56-582 C.

[5] It is likely that the Company's unbundled rates for generation will often be less than the market price for generation, with the result that the wires charge will not apply. In this instance, of course, few customers will have reason to take service at higher rates from the Company's competitors.

expense through continued operation of its fuel recovery factor. Finally, all incumbent electric utilities have the ability to petition for adjustment of their rates in the event of financial distress, also under Code § 56-582 B. AEP-VA should have ample opportunity through rates set as provided for by statute to recover all expenses associated with its generation related regulatory assets so long as capped rates are in place.

New service fees. Although not a contested issue, we must decide whether the Act permits the imposition of a variety of new service fees proposed by the Company. AEP-VA takes the position that the fees are allowed by Code § 56-582, while the Staff took no position on the legal issue, but stated that if we were to find that the Code permitted fees, then the fees and charges contained in the Stipulation were reasonable.

Section 56-582, which establishes the parameters for capped rates, states that capped rates shall "include rates for new services where, subsequent to January 1, 2001, rate applications for such services are filed by incumbent electric utilities with the Commission" and are thereafter approved by the Commission. The instant application, to the extent that it requests the approval of fees for new services, falls within the meaning of this provision. Accordingly, we will permit the fees set out in the Unbundling Stipulation to be imposed and collected by AEP-VA, except for the proposed fees for competitive supplier

registration and customer switching, which we do not find to be "new services" provided by the Company within the meaning of the Act.[6] There will certainly be additional costs of doing business in the new choice environment, but like most other cost increases[7] they are not recoverable because of the capped rate limitation of the Act. When the Company is eligible to file its next distribution rate case, and we are free to examine both increasing and decreasing Company expenses, we will be able to consider the recovery of these costs.

The Staff offered alternative proposals for the treatment of metering costs; one option assigned the costs to the distribution function and the other allocated the costs among the distribution, transmission and generation functions. We concur with the Staff that there are practical difficulties at this time in allocating these costs and the rates approved herein reflect the assignment of these costs to the distribution function alone.

Finally, the Staff recommended that the Company conduct annual compliance audits to ensure that its internal controls

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[6] We so found for a similar fee proposed by another utility in our Final Order of April 28, 2000, in Case No. PUE980813, *Commonwealth of Virginia* ex rel. *State Corporation Commission, Ex Parte: In the Matter of considering an electricity retail access pilot program-Virginia Electric and Power Company.*

[7] Other than the adjustments permitted for tax changes, fuel expense and financial distress under Code § 56-582 B.

are adequate and effective and we find such recommendations reasonable and appropriate.

Accordingly, IT IS ORDERED THAT:

(1) The Stipulations offered in this matter, and appended as exhibits hereto, are reasonable, in the public interest, and shall be adopted as modified in this Order.

(2) The proposed modification to the Company's line extension policy is denied.

(3) The Company's proposal regarding mandated installation of interval metering is denied; the Company may offer interval metering to any of its customers at the rate found reasonable herein.

(4) Net generation related regulatory assets and related amortization expense shall be assigned to the generation function and if booked shall be reflected in that function.

(5) The Company's proposed fees for new services are reasonable and are adopted, except for the proposed fees for customer switching and registration of competitive suppliers, which we find not to be new services.

(6) On or before July 1, 2002, AEP-VA shall submit a report to the Commission's Division of Energy Regulation regarding the replacement of power caused by the outage of the Cook Nuclear Power station.

(7) On or before May 1 of each calendar year until ordered otherwise, AEP-VA shall submit to the Division of Public Utility Accounting the results of its annual audit of its internal controls, and shall as well submit any proposed changes to these controls to the Division of Public Utility Accounting.

(8) The Commission Staff shall, as necessary, conduct audits and reviews of the Company books, records, and work papers and conduct meetings to ensure compliance with § 56-590 of the Code of Virginia and the regulations put forth by the Commission in Case No. PUA00029

(9) This matter is continued for further orders of the Commission.